

CASE OPENER The Martha Stewart Case On December 27, 2001, Martha Stewart's stockbroker, Peter Bacanovic, informed Stewart that two of his clients, Samuel Waksal, CEO of the biopharmaceutical company ImClone, and Waksal's daughter, had just sold all of their ImClone stock. Waksal secretly knew that the FDA was about to reject Erbitux, a key cancer drug ImClone had developed. Stewart did not know about the impending FDA rejection of Erbitux, and information about Waksal's sale of ImClone's stock was not available to the public. After receiving the information about Waksal's transaction, Stewart instructed her broker to sell all of her shares of ImClone stock. The following day, the FDA announced its rejection of Erbitux, and ImClone's stock price plummeted 16 percent. Stewart's timely trade allowed her to avoid a \$45,673 loss. Eighteen months later, the Securities and Exchange Commission (SEC) filed charges against Stewart and her broker for illegal insider trading and securities fraud.¹ Did Martha Stewart violate federal securities law? Why or why not? Did Martha Stewart's broker violate securities law? Why or why not?

LEARNING OBJECTIVES LO 23-1 Identify types of securities. LO 23-2 Outline the requirements imposed by the Securities Act of 1933. LO 23-3 Explain how the Securities Exchange Act of 1934 regulates security trading. LO 23-4 Recall the legislative Acts that regulate investment companies. LO 23-5 Identify state laws that regulate securities.

Page 553 Companies frequently need to raise money to expand. One way they raise money is by issuing securities. For example, corporations issue corporate securities—stocks and bonds—to raise capital for corporate expansion. However, a security is simply a piece of paper; it has no intrinsic value. Consequently, without securities regulations, corporations could easily commit fraud by issuing large numbers of securities and then refusing to repay them. Thus, the government heavily regulates securities issuance and trading. Securities regulation is a relatively recent body of law. Before the Great Depression, government did not regulate securities, and fraudulent transactions occurred frequently. After the stock market crash in 1929, Congress passed several laws to regulate securities markets. This chapter begins by defining security. It then examines federal securities regulations. Finally, the chapter briefly discusses state securities regulations.

What Is a Security? LO 23-1 Identify types of securities. Physically, a security is merely a piece of paper, as illustrated in Figure 22-3 of the previous chapter. But when investors buy securities, they are not buying a piece of paper. They are buying what the paper represents. The value of the security

is based on what the paper represents. Earlier, we loosely defined securities as stocks and bonds. To be more precise, securities include stocks, bonds, debentures, and warrants. Furthermore, certain items mentioned in securities acts, such as interests in oil and gas rights, are securities. In some cases, courts have even defined cosmetics, vacuum cleaners, and cemetery lots as securities. Finally, investment contracts, contracts in which individuals invest money with the expectation of making a profit, are securities. How can so many different things be securities? The Securities Act of 1933 offers a complicated definition of security, and as a result, courts have struggled when determining whether a particular instrument is a security. In an effort to provide a framework for analysis, the U.S. Supreme Court stated in the 1985 case *Landreth Timber Co. v. Landreth* that courts should presumptively treat as a security any financial instrument designated as a note, stock, bond, or other instrument named in the 1933 act. If the instrument in question does not have the characteristics of an instrument specifically named in the 1933 act, the courts apply a three-part test. In the classic 1946 case *SEC v. W.J. Howey Co.*,² the U.S. Supreme Court defined a security as an (1) investment in a common enterprise with the (2) reasonable expectation of profit gained (3) primarily or substantially from others' efforts. Anything that meets these three criteria is subject to security law. Case 23-1 illustrates how courts apply the Howey test. CASE 23-1 SECURITIES AND EXCHANGE COMMISSION v. ARCTURUS CORPORATION United States District Court, N.d. Texas, Dallas Division 171 F.SUPP.3D 512 (2016) FACTS: Arcturus Corporation and Aschere Energy, LLC are two companies owned by Leon Parvizian. The companies were Texas corporations based in Dallas that offered and sold interests in gas and oil drilling ventures. Parvizian and his companies sold the drilling interests, which were officially called "Joint Ventures," through limited liability companies that cold-called United States residents. In 2013, the SEC filed an action against Parvizian, Arcturus, Aschere, and the cold-calling contractors. The SEC alleged that the Joint Ventures offered and sold by Arcturus and Aschere were actual securities and Parvizian was trying to avoid securities regulation by naming them Joint Ventures. The defendants filed a motion to dismiss which was rejected by the trial court. Both the SEC and the defendants subsequently moved for summary judgment against each other. The crucial first question the court had to decide was whether the Joint Ventures were in fact securities regulated under the Securities Act of 1934. The Securities and Exchange Commission (SEC) filed an action against the defendant based on believed violations of securities laws. Defendants argued that they were simply involved in a joint venture, and were not attempting to sell securities. ISSUE: Were Parvizian's investments truly "Joint Ventures," or

were they disguised securities? REASONING: To determine whether Parvizian's investment scheme involved securities, the court used the Howey test. The Howey test has three prongs: (1) an investment of money; (2) in a common enterprise; (3) on an expectation of profits to be derived solely from the efforts of individuals other than the investor. There was no dispute that the scheme involved individuals investing money in oil and gas drilling, a common enterprise. To prove the third prong, the court used the Williamson test, which essentially analyzes how much control over business operations the so-called "venturers" have and how much experience and knowledge they have of the industry in question. The court determined that the venturers had practically no control over the operation of the "venture" and that the venturers knew nothing about the oil and gas industry. In addition, Parvizian had complete control over the investment accounts and the venturers had no power to replace him. Having satisfied all three factors of both tests, the court ruled that the "Joint Ventures" were indeed securities and therefore subject to the Securities Acts. DECISION AND REMEDY: Affirmed in favor of the SEC. SIGNIFICANCE OF THE CASE: If it looks and functions like a security, it's probably a security. Using creative names for securities doesn't mean they aren't subject to SEC regulations. This case is a good example of how the Howey test can detect securities by any other name. CRITICAL THINKING Suppose someone makes an inference about a court case based on the three Williamson factors and states "since joint ventures are not investment contracts, none of the three Williamson factors must have been met." Is the statement logically sound? Why do you think the creators of the three Williamson factors decided that any one criteria could identify the contracts as investment contracts? ETHICAL DECISION MAKING Do you think Parvizian would have sent the angry email to Ullrey if he had applied the disclosure test before he sent it?

Securities Regulation Two crucial acts regulate securities transactions. The Securities Act of 1933 regulates how companies issue corporate securities; the Securities Exchange Act of 1934 oversees the purchase and sale of securities. Both attempt to provide greater stability to securities transactions. First, the acts mandate that investors must have access to certain information when deciding whether to buy or sell securities. Second, the acts strive to curb fraudulent securities transactions. The Securities and Exchange Commission The 1934 act created the Securities and Exchange

Commission (SEC), an independent agency whose function is to administer federal securities laws. The SEC is headed by five individuals appointed by the president. These five individuals serve fixed five-year terms. Page 555 GLOBAL Context Digital Archive Japan/Alamy Stock Photo Sweden's Securities Market The Swedes divide securities into bonds and shares. Individuals invest in either the bond market or the stock market. Companies issue bonds to boost funds from sources outside their shareholders. Bondholders have a right to a fixed rate of interest regardless of whether the company earns a profit. Bondholders do not, however, have a right to take part in company decision making. Companies issue shares to increase their equity capital. Unlike bond interest payments, shareholders' returns vary with the company's profits. Because shareholders' interests are closely tied to the success of the company, shareholders have a voice within the company. Generally, this voice comes in the form of a vote at general meetings. Regulation of the stock and bond markets in Sweden is unique because Sweden has no equivalent of the SEC. Instead, banks themselves oversee the issuance of shares and bonds. The SEC has a number of responsibilities. First, it is responsible for the enforcement of securities laws. Thus, in response to an allegation of violation of securities law, the SEC investigates and, if necessary, initiates an enforcement action against the violator. Enforcement actions often include penalties or injunctive remedies. If the violation is severe enough to warrant criminal prosecution, however, the Fraud Section of the Criminal Division of the Department of Justice will prosecute the alleged violator. Second, the SEC interprets the securities acts and adopts rules to achieve the purposes of the acts. Thus, the SEC passes securities transaction regulations that have the force of law. Third, the SEC regulates the activities of securities brokers, dealers, and advisers. All securities dealers and brokers must register with the SEC. Fourth, the SEC regulates the trade of securities on securities exchanges. As you read about securities regulations in this chapter, remember that the SEC is responsible for their administration and enforcement. Exhibit 23-1 traces how the SEC's regulatory powers have evolved. Exhibit 23-1 The Expansion of SEC Powers in the 1990s Securities Enforcement Remedies and Penny Stock Reform Act of 1990 Permits the SEC to Issue a cease-and-desist order against a violator of any federal securities law. Seek civil money penalties against any violators. Create rules to require brokers and dealers to provide information concerning prices and risks associated with the penny-stock market. Market Reform Act of 1990 Allows the SEC to suspend securities trading if prices vary excessively in a short time period. Securities Acts Amendments of 1990 Permit the SEC to seek punishment of violators of foreign securities laws.

National Securities Markets Improvement Act of 1996 Permits the SEC to exempt persons, securities, and transactions from securities regulations. Sarbanes-Oxley Act of 2002 Increases corporate disclosure requirements. Penalizes violators of securities laws more heavily. Holds corporate executives responsible for errors in corporate reports filed with the SEC. Requires earlier filing of financial and stock transaction reports. Creates and establishes SEC oversight over the Public Company Accounting Oversight Board to regulate public accounting firms. Page 556 Other countries have bodies that serve functions similar to those of the SEC. In Singapore, for example, the government controls securities markets through the Securities Industry Council. The council is an advisory board to the minister of finance, who, on the basis of the council's advice, issues guidelines for exchanges, mergers, and trading.

The Securities Act of 1933 LO 23-2 Outline the requirements imposed by the Securities Act of 1933. Congress passed the Securities Act of 1933 in reaction to the mistrust of securities transactions before the Great Depression. Thus, a function of the act was to legitimize security transactions by requiring the registration of securities offered to the public. Through the registration process, investors have more information to make better-informed decisions about their securities purchases. Section 5 of the 1933 act mandates that any corporation, partnership, association, or individual that offers the sale of securities to the public through the use of mails or through any facility of interstate commerce must register that security, unless it qualifies for an exemption (discussed later in this section). Any issuer of securities must file a written registration statement and a prospectus with the SEC. Registration Statement Although the SEC requires different types of companies to complete slightly different registration forms, the SEC requires certain elements from all companies. The registration statement generally contains (1) a description of the securities offered for sale, (2) an explanation of how proceeds from the sale of the securities will be used, (3) a description of the registrant's business and properties, (4) information about the management of the company, (5) a description of any pending lawsuits in which the registrant is involved, and (6) financial statements certified by an independent public accountant. Caution: Although the SEC requires the registration of securities, the SEC does not approve these securities. In other words, the SEC does not make any judgment about

the worth of securities; it simply enforces the requirement that issuers must provide certain information to potential buyers. Prospectus Along with filing a registration statement, issuers of securities must also file a prospectus with the SEC. A prospectus is a written document that contains most of the information that appears in the registration statement. The prospectus is different from the registration statement, however, because it is an advertising tool that issuers distribute to potential investors, who rely on the prospectus to help decide whether they should buy the securities. The SEC requires, but cannot guarantee, the accuracy of facts stated in the registration statement and prospectus. If an issuer makes a false or misleading statement in a registration statement, the issuer can be subject to criminal or civil penalties. These penalties are discussed later in the chapter.

Periods of the Filing Process The filing process consists of three periods: prefiling, waiting, and posteffective.

Prefiling Period The prefiling period begins when an issuer starts to think about issuing securities, and it ends when the issuer files the registration statement and prospectus with the SEC. Before filing these documents, the issuer cannot make any offers to sell securities. The issuer can, however, negotiate with underwriters, investment banking firms that purchase securities from the issuing corporation with the intent to sell them to brokerage houses, which then sell them to the public.

Page 557 Because they cannot offer to sell securities during the prefiling period, issuers, officers, directors, and underwriters usually try to avoid generating publicity about possibly issuing securities because the SEC may construe such publicity as an attempt to condition the market to generate interest in the securities. In fact, the SEC could consider speeches or press releases mentioning the potential issuance of securities to be an offer. The issuing firm is permitted, however, to publish a notice about the prospective offering, including the name of the issuer as well as a description of the potential securities, but the notice may not include the name of the underwriter.

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China's Securities Regulation The purpose of securities regulation in China is similar to that of the SEC in the United States. The Securities Law of the People's Republic of China, for example, contains 12 chapters that regulate items such as stock issuance, stock transactions, prohibited transactions, stock exchanges, securities companies, securities registration, and much more. The Securities Law of China does not approve registration of securities; instead, securities are approved by the regulatory body under the State Council of China.

Waiting Period Once an issuer files a registration statement and prospectus, the waiting period begins. During this period, the SEC reviews the information filed by the issuing firm. Issuers must wait 20 days

after the filing date to sell their securities. During the waiting period, issuers may make oral offers to sell the securities and may distribute a red-herring prospectus—a prospectus with a notice written in red print at the top of the page warning investors that the registration has been filed with the SEC but is not yet approved. Moreover, the issuer may publish a tombstone advertisement, a brief ad with a format similar to that of a tombstone.

Posteffective Period The posteffective period begins when the SEC declares the registration statement effective, and it ends when the issuer sells all securities offered or withdraws them from sale. During this time, investors may buy and sell the securities, but purchasers must receive a final prospectus, a version of the prospectus the buyer must receive at the point of sale. If an issuer does not send the purchaser a final prospectus, the issuer has violated the 1933 Securities Act. BUT WHAT IF? . . . WHAT IF THE FACTS OF THE CASE OPENER WERE DIFFERENT? Let's say in the Case Opener that Waksal had submitted his registration statement to the SEC. He went through the waiting period and eventually the SEC declared his registration statement to be effective. Waksal thinks that he has now completed all the periods of the filing process. Is he correct? Is he missing anything?

Special Registration Provisions Amendments to the 1933 act stipulate more relaxed registration requirements for companies that have consistently satisfied applicable registration requirements. For example, shelf registrations permit certain qualified issuers to register securities that they will sell off the shelf on a delayed or continuous basis in the future. SEC Rule 415 requires corporations using shelf registrations to keep information in the original registration accurate and up to date. Exemptions under the 1933 Act

Although these complex registration requirements are standard for most securities, they do not apply to all securities in all situations. Some securities are exempt because of the nature of the securities themselves—exempt securities—and others are exempt when exchanged in certain ways—exempt transactions.

Page 558 Exempt Securities The 1933 act provides that certain securities are exempt from the registration procedures previously described. These securities are unregistered, unrestricted securities, and they include Securities issued by governments, including municipal, state, and federal governments. Securities issued by nonprofit issuers, such as religious institutions or charitable organizations. Securities issued by financial institutions supervised by banking associations. Securities issued as a result of corporation reorganization in which one security is exchanged for another security. Stock dividends and stock splits. Insurance and annuity contracts issued by insurance companies. Securities issued by federally regulated carriers (i.e., railways). Short-term notes with a maturity date that does not

exceed nine months. Securities sold before July 27, 1933. An issuer's offer of up to \$5 million in securities in a 12-month period. Although the last exemption permits the issuer to avoid the complex requirements of full registration, Regulation A nevertheless requires the issuer to file certain reports with the SEC. For example, the issuer must file a notice of issue and an offering circular and provide the offering circular to investors before sale of the securities. Even with these requirements, however, the registration process under Regulation A is much less burdensome than the full registration process. For example, Regulation A permits issuers to test the waters for interest in their securities before preparing the offering circular, selling any securities, or gaining the commitment of interested buyers.

Exempt Transactions If a security does not fall under one of the exempt categories previously described, an issuer can nevertheless avoid registering the security by making certain exempt transactions. Such securities are unregistered restricted securities. Issuers might want to avoid the registration process because it can be costly, complicated, and time-consuming. Exempt transactions offer an opportunity to save time and money. Consequently, many issuers sell securities through exempt transactions. Although these transactions are exempt from registration, issuers must still provide investors with information about the securities, such as annual reports and financial statements. Exempt transactions include limited offers, intrastate issues, and resales of securities.

Limited Offers. Certain securities transactions known as limited offers are exempt from the registration process because they either involve small amounts of money or are offered only to sophisticated investors. The investors who participate in limited offers generally do not need the protection afforded by the registration process. The SEC's Regulation D enumerates three exemptions for limited offers (Rules 504, 505, and 506). Section 4(6) of the 1933 act contains an additional limited-offer exemption.⁵

Private Placement Exemption (Rule 506) Issuers who make private offerings of securities are exempt from the registration process. These issuers, however, cannot advertise their private offerings to the general public. This exemption, usually referred to as the private placement exemption, allows firms to issue an unlimited number of securities to an unlimited number of accredited investors. Consequently, firms can easily raise large amounts of capital. Firms may not, however, issue to more than 35 unaccredited investors. The SEC defines an accredited investor as⁶

Any natural person who has a net worth of at least \$1 million. Any natural person whose annual income has been at least \$200,000 for the two previous years and expects to make at least \$200,000 in the current year. Any corporation or partnership with total

assets in excess of \$5 million. Insiders of the issuers, such as executive officers or directors. Registered investment companies, colleges and universities, banks, and insurance companies. Page 559 The SEC assumes that accredited investors are better able to evaluate the financial risk associated with buying securities. Consequently, government protection in the form of required registration is less imperative. The SEC also requires firms selling to unaccredited investors under Rule 506 to believe that these investors have expertise regarding securities trading. The firms must believe that the investors, or their representatives, have reasonable ability to evaluate the financial risk associated with purchasing securities. If a firm privately offers any unaccredited investor the opportunity to purchase securities, all investors must receive the basic information contained in the registration statement (i.e., information about the issuing company and the securities). If no unaccredited investors are involved, however, the issuer does not have to disclose any information. Although firms do not have to register these exempt securities with the SEC, they must notify the SEC of any sales made under the exemption. The private placement exemption provides one of the easiest ways for firms to raise capital. Instead of making a public offering, firms can simply make a private offering to investors capable of ascertaining the risk associated with buying securities. The firms cannot, however, advertise the securities to the general public. Rule 505 Rule 505 is very similar to Rule 506, but it has two important differences. First, according to Rule 505, a firm's private offerings may not exceed \$5 million in a 12-month period, whereas under Rule 506, a firm may issue an unlimited number of securities. Second, according to Rule 506, if a firm issues securities to unaccredited investors, it must believe that they have the knowledge to evaluate the risk associated with the security. In contrast, under Rule 505, firms need not believe that investors have the reasonable ability to evaluate the risk of purchasing securities. Rule 504 Noninvestment firms—firms that do not engage primarily in the buying and selling of securities—that offer no more than \$1 million in securities over a 12-month period are exempt from registration. An unlimited number of both accredited and nonaccredited investors may purchase these securities; however, the firms must notify the SEC of their securities sales. Issuers need not disclose any information to investors. Section 4(6) If a firm offers securities only to accredited investors for an amount less than \$5 million, the issuer is exempt from registration. An unlimited number of accredited investors may participate in the transactions, but no unaccredited investors may buy these securities. Firms may not advertise these securities to the public. Issuers do not have to disclose any information to investors, but they must notify the

SEC of any sales under this exemption. Moreover, investors who want to resell these securities must register them with the SEC.

Intrastate Issues.

Under Section 3 of the 1933 act, any security offered or sold to a permanent resident of the single state where the issuer of the security resides and does business is exempt. Thus, local businesses can rely on local investors to raise an unlimited amount of capital without registration. Courts and the SEC have interpreted this exemption very narrowly. Issuers must do at least 80 percent of their business within the state, receive at least 80 percent of their profits within the state, have at least 80 percent of their assets within the state, plan to use at least 80 percent of the profits within the state, and have their main offices in the state. During the period of sale and at least nine months after the period of sale, buyers of these securities under the intrastate exemption may not resell them to nonresidents. Issuers must take precautions against interstate resales.

Resales.

The 1933 Securities Act creates an exemption for “transactions by any person other than an issuer, underwriter, or dealer.” Because another section of the act exempts dealers and brokers, only issuers and underwriters are not exempt from registering resales of securities. Consequently, the average investor does not have to register securities when they want to sell. If the investor acquired them through sales under Rule 505, Rule 506, or Section 4(6) (e.g., intrastate issues and limited offers), they are restricted securities. If an investor wants to resell a restricted security, they must register the securities unless they follow Rule 144 or Rule 144a.

Page 560 Rule 144

Under Rule 144, any person wanting to resell a restricted security is exempt from registration if certain criteria are met. First, the public must have access to adequate current information about the issuer. Second, the person selling the restricted security must have owned the security for at least two years. Third, the seller must sell the restricted securities in limited amounts in unsolicited broker transactions. Fourth, the seller must notify the SEC of the sale. If a seller is not an affiliate of the issuer and has owned the securities for three years, they may sell the securities in unlimited amounts and are not subject to any of the criteria under Rule 144 for an exemption. An affiliate is a person who controls, is controlled by, or is in common control with the issuer. The 1933 act restricts sales by affiliates much more than sales by nonaffiliates. If an affiliate sells restricted or nonrestricted securities, they must meet all but one of the criteria to be exempt from registration. The affiliate does not need to hold a nonrestricted security for two years before reselling.

Violations and Liability

If the SEC uncovers a potential violation of the 1933 act, it can (1) take administrative action, (2) take injunctive action, or (3) recommend criminal prosecution. If the SEC takes administrative action, it conducts a

formal investigation of the potential violation by calling relevant witnesses to testify or produce evidence. If, through this investigation, the SEC uncovers evidence of a violation, the SEC may order an administrative proceeding before an administrative law judge, who can impose sanctions and even revoke a security's registration. Usually the SEC takes injunctive action when it believes that a defendant is likely to continue to violate the law. Thus, the SEC may seek an injunction to prevent issuers from advertising securities by mail. In the Case Opener about Martha Stewart, the SEC sought an injunction prohibiting Stewart and her broker from violating securities laws and limiting her activities as an officer of a public company. Finally, if the SEC recommends criminal action, the Department of Justice prosecutes criminal charges against the violators. Criminal penalties include a fine of up to \$10,000, imprisonment for up to five years, or both. How might an issuing company violate the 1933 Securities Act? First, a company violates the act if it intentionally misleads investors by omitting or falsifying information on a registration statement or prospectus. Second, if a company is negligent in discovering a fraudulent statement, it can be liable. Third, an issuing company violates the act if it sells securities before the effective date of the registration statement. Issuers charged with a violation of the 1933 act can raise several defenses. A company charged with the first or second violation previously described may claim that the omitted or false statement was immaterial to the sale of the security. Similarly, if the issuer can prove that the plaintiff was aware of the omission or false statement when they bought the security, the defendant can avoid liability. Any defendant except the issuer can assert the due diligence defense. This defense requires the defendant to demonstrate that they investigated the registration statement and had reasonable grounds to believe that the statement was accurate and had no omission of material facts. If a defendant sold securities before the effective date of registration, however, they will almost certainly be liable because the 1933 act provides no defenses for this violation. If an investor purchased securities and suffered damages as a result of an issuer's false or misleading statement, the investor is entitled to bring a civil suit to recover their losses. The burden of proof falls on the investor to demonstrate this incomplete or inaccurate disclosure of facts.

The Securities Exchange Act of 1934 LO 23-3 Explain how the Securities Exchange Act of 1934 regulates security trading. Whereas the 1933

Securities Act regulates the issuance of securities, the 1934 Securities Exchange Act regulates the subsequent trading (resale) of securities, chiefly through the required registration of securities exchanges, brokers, dealers, and national securities associations. Moreover, the act requires certain issuers to file periodic reports with the SEC. The 1934 act also permits the SEC to monitor securities markets for fraud and market manipulation. Page 561

In one of the most closely watched business cases in years, the Supreme Court, in a 5-3 decision, protected those who are only secondary players in securities fraud, as long as the public did not rely on any explicit statements or actions by the secondary players. The case appears to limit the liability of accountants, lawyers, and others who may know about questionably fraudulent corporate behavior but can establish that they are not directly involved in it. The Case Nugget explains this case. CASE Nugget Aiders and Abettors Get a Free Pass from the Supreme Court *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.* United States Supreme Court 128 S. Ct. 761 (2008) The facts in the case are fairly straightforward. At the request of Charter, which in mid-2000 was falling short of its cash-flow target, Scientific-Atlanta and Motorola agreed to increase their prices for the cable boxes they sold to Charter and to use the extra money to buy advertising on Charter's cable stations. The arrangement allowed Charter to treat the advertising purchases as current revenue but list the money spent on cable boxes as a capital expense. By recording the advertising purchases as millions in extra revenue, Charter fooled its auditor into approving a financial statement that showed it met projected revenue and operating cash-flow numbers. In rejecting the shareholders' claim against Scientific-Atlanta, the Court majority said that shareholders could not sue bankers, lawyers, and other third parties who did not directly mislead investors but worked with corporations that did. The Court reasoned that the key test for liability is whether investors relied on an entity's actions or statements, and, in this case, investors had no knowledge of deceptive acts during the time in question. The Court noted that the primary punishment of such secondary offenders would come from criminal prosecutions and enforcement actions by the SEC. Shareholder activists are concerned that this decision, in effect, offers less protection to shareholders in a variety of situations. Their concerns were strengthened when less than a week after the Stoneridge case, the high court turned down an appeal in a class action case in which several plaintiffs alleged that three investment banks, Credit Suisse, Merrill Lynch, and Barclays Bank, had aided and abetted Enron in the fraudulent practices that led to the giant corporation's filing of bankruptcy. The plaintiffs were seeking up to \$40 million in damages. The court of appeals in the case

held that the shareholders could not sue the banks for fraud because the banks did not have primary liability for the matter under federal law. Section 10(B) and Rule 10B-5 One of the most important sections of the 1934 act is Section 10(b), which prohibits the use of manipulative and deceptive devices to bypass SEC rules. Within this section, subsection 5 prohibits fraud associated with the purchase or sale of all securities. Thus, even though securities may be exempt from registration, they are still subject to Rule 10b-5: It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange, to employ any device, scheme, or artifice to defraud, to make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in light of circumstances under which they were made, not misleading, or to engage in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security. Both Section 10(b) and Rule 10b-5 play an important role in preventing insider trading. Page 562 Insider Trading When a company employee or executive uses material inside information to make a profit, they are engaging in insider trading. Insider trading is illegal because it gives the violator an important advantage over the general public and shareholders. Section 10(b) and Rule 10b-5 define insiders as corporate officers, directors, employees, lawyers, consultants, accountants, majority shareholders, or any other individuals who receive private information regarding the trading of securities. A company employee or executive who has inside information may be liable, depending on whether the information is material. If there is a material omission or misrepresentation during a securities transaction, the individual has violated Section 10(b) and Rule 10b-5. If the omission or misrepresentation is not material, however, the individual is not liable. Examples of material information include the following: A change in the status of litigation against the company. A change in dividends. A contract for the sale of corporate assets or for the purchase of assets. A new product, process, or discovery. A significant change in the financial status of the company. According to the SEC, an individual with material inside information should either refrain from using the information or disclose the information to the other parties involved in the transaction.⁷ Case 23-2 is a classic example of how courts address insider trading. CASE 23-2 SECURITIES AND EXCHANGE COMMISSION v. TEXAS GULF SULPHUR CO. U.S. Court of Appeals for the Second Circuit 401 F.2d 833 (1968) FACTS: In June 1963, Texas Gulf Sulphur (TGS) acquired the option to buy land in Timmons, Ontario. Preliminary drilling in November 1963 suggested that the

land held great amounts of copper and zinc. This information was supposed to be kept secret; not even officers and executives at TGS were supposed to know about the results of the drilling. TGS acquired the land and resumed drilling in March 1964. From November 1963 to March 1964, certain directors, officers, and employees of TGS received tips and purchased TGS stock or options to buy shares at a fixed price. When drilling began in November 1963, these people had owned 1,135 shares of TGS stock and possessed no calls; thereafter they owned a total of 8,235 shares and possessed 12,300 calls. In April 1964, when rumors of a major mineral find appeared in newspapers, TGS publicly claimed that the rumors had no factual basis; a few days later TGS confirmed that the strike was expected to yield many million tons of ore. Between the days that TGS claimed the rumors were false and later confirmed the rumors, two defendants, Clayton and Crawford, ordered a combined total of 500 shares of TGS stock. The SEC brought suit against TGS and 13 of its directors, officers, and employees for violation of Section 10(b) of the Exchange Act and SEC Rule 10(b)-5, seeking an injunction to prevent TGS from publishing misleading press releases and requesting rescission of TGS's purchases and stock options. The district court dismissed the charges against all defendants but Clayton and Crawford, and the SEC appealed. ISSUE: Did the corporate employees possess inside information that should have precluded them from trading in the company's stock? REASONING: The essence of the Rule is that anyone in possession of material inside information must either disclose it to the investing public, or, if they cannot or choose not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed. The basic test of materiality ". . . is whether a reasonable man would attach importance . . . in determining his choice of action in the transaction in question. . . ." This, of course, encompasses any fact ". . . which in reasonable and objective contemplation might affect the value of the corporation's stock or securities. . . ." Such a fact is a material fact and must be effectively disclosed to the investing public prior to the commencement of insider trading in the corporation's securities . . . disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities. . . . Here . . . knowledge of the possibility . . . of the existence of a mine of the vast magnitude indicated by the remarkably rich drill core located rather close to the surface . . . might well have affected the price of TGS stock and would certainly have been an important fact to a reasonable, if speculative, investor in deciding whether he should buy, sell, or hold. DECISION AND

REMEDY: The court found that the “transactions in TGS stock or calls by individuals apprised of the drilling results were made in violation of Rule 10b-5.” The judgment was reversed in favor of the plaintiff.

SIGNIFICANCE OF THE CASE: The case is significant because it clarifies the type of information a person may possess that qualifies him as an inside trader for purposes of the law.

CRITICAL THINKING How does the reasoning in this case highlight the link between business law and business ethics?

ETHICAL DECISION MAKING What values are being emphasized by the prohibition on insider trading?

Page 563 BUT WHAT IF? . . . WHAT IF THE FACTS OF THE CASE OPENER WERE DIFFERENT? Let’s say in the Case Opener that Stewart had heard on the news about the rejection of Waksal’s new drug. She immediately had her agent sell her stock as fast as she could and she beat a lot of other people to it. Is there anything wrong with Stewart’s action in this case? The Private Securities Litigation Reform Act of 1995 Although Rule 10b-5 was designed to encourage disclosure of accurate information, one of its unintended side effects was the deterrence of forecasts. Shareholders who purchased stock in corporations with high earning forecasts often brought suit against the corporations’ directors if actual corporate earnings fell short of forecast earnings, alleging that the directors violated Rule 10b-5 by disclosing misleading financial information. Congress attempted to remedy this problematic side effect by passing the Private Securities Litigation Reform Act (PSLRA) of 1995. Among other things, the act provides a “safe harbor” from liability for publicly held issuers who make financial forecasts as long as the forecasts are “accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.”⁸ Innovative shareholders attempted to subvert the PSLRA by suing corporate directors in state courts. Congress responded to these efforts by passing the Securities Litigation Uniform Standards Act of 1998. This act strictly limits shareholders’ ability to bring class action suits against nationally traded corporations.

Outsiders and Insider Trading Not only may insiders be liable for omitting or misrepresenting material information, but certain outsiders may also be liable through two theories: misappropriation theory and the tipper/tippee theory. Consider whether Martha Stewart is liable under either theory.

Page 564 Misappropriation Theory In addition to being a theory of tort (see Chapter 7), misappropriation can establish liability for insider trading. Misappropriation theory holds that if an individual wrongfully acquires (misappropriates) and uses inside information for trading for their personal gain, they are liable for insider trading. Because they wrongfully acquire inside information, they are essentially stealing information to use for their

benefit. Because it expands the SEC's power, application of misappropriation theory to insider trading has not gone uncontested. The *United States v. Carpenter* Case Nugget describes the first case in which the SEC convinced the courts to apply misappropriation theory to Rule 10b-5. Over 10 years later, in *United States v. O'Hagan*, the U.S. Supreme Court conclusively established that misappropriation theory is applicable to Rule 10b-5.⁹

Tipper/Tippee Theory The tipper/tippee theory holds that any individual who acquires material inside information as a result of an insider's breach of duty has engaged in insider trading. This individual, one who has received a tip from an insider, is called a tippee. The insider who gives the inside tip is called the tipper. Suppose that Jerry (the tipper) gives material inside information to Elaine (the tippee). Jerry is liable because he is passing on inside information. Furthermore, Elaine is liable if she makes trading decisions based on information that she should know is not public. Jerry is liable for any profits made by Elaine. Now suppose that Elaine passes the tip on to George. Elaine is now a tipper, and George is a tippee. Both Elaine and Jerry are liable for the profits made by George. George is liable for the profits of his transactions if he knew or should have known that the material information was not public. In some business areas, such as public accounting, employees may be exposed to sensitive information when working for a client. As a preventive measure, businesses will often impose strict rules to ensure that their employees keep client information private. However, regardless of the regulations, some unethical employees may attempt to use classified client information to make money through insider trading. For example, in 2008 two PricewaterhouseCoopers employees were caught using their access to client information to engage in insider trading. One of the employees, Patrick Borchard, worked in PwC's Transaction Advisory Group assisting corporate clients interested in mergers or acquisitions. As a member of the Transaction Advisory Group, Borchard often heard about corporate takeovers before they were announced publicly. Rather than keeping the information private, Borchard tipped off his co-worker, Gregory Raben, to confidential client plans so that Raben could trade on the information and make a profit. Additionally, Raben tipped off two of his own acquaintances to the information provided by Borchard. Eventually, PwC noticed what Raben and Borchard were doing and alerted the SEC. Both Borchard and Raben were charged by the SEC with insider trading and were required to not only pay fines but also pay back the trading profits earned with client information.¹⁰

Sentences for the tipper or tippee can be harsh, as Case 23-3 illustrates. *CASE 23-3 MARSHALL v. UNITED STATES SOUTHERN DISTRICT OF NEW YORK No. 17-cv-2951 (SDNY 2018)* FACTS: John Marshall

and Alan Tucker began working together at Marshall's financial consulting firm in approximately 1995. In addition to working at his firm, Marshall served as a member of the board of directors of the International Securities Exchange ("ISE"). From late 2006 through early 2007, the ISE engaged in merger discussions with several other exchanges. In his role on the ISE Board of Directors, Marshall learned material, nonpublic information relating to discussions about that potential merger. From late 2006 through April 2007, Marshall provided Tucker with that material, nonpublic information. Marshall instructed Tucker "to make certain trades from which they would share the profits." Tucker performed those transactions, and when the merger was made public around April 30, 2007, Marshall and Tucker "made a significant profit." On March 13, 2008, the Government filed a complaint charging Marshall, Tucker, and a third defendant with several counts of securities fraud, to which Marshall pled guilty. Marshall now files a petition for a writ of error because, he alleges, he is innocent of the crimes he pled guilty to. Specifically, he argues that the elements of insider trading were not met. ISSUE: Had Marshall's actions met the elements of insider trading?

REASONING: Petitioner contends that he was innocent of insider trading, or of a conspiracy to commit that offense, because "he never received or expected to receive any benefit of any kind in exchange for the informational tip he gave to Alan Tucker." The Supreme Court recently clarified the personal benefit requirement for tipper liability in *Salman v. United States*, 137 S. . . There, the Supreme Court explained, "[A] tippee is exposed to liability for trading on inside information only if the tippee participates in a breach of the tipper's fiduciary duty," i.e. if the tipper 'will benefit, directly or indirectly, from his disclosure,' . . . 'such as [through] pecuniary gain or . . . reputational benefit that will translate into future earnings.'" In other words, "the disclosure of confidential information without personal benefit is not enough." However, to be liable for trading on insider information a tipper need not receive "something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends." Instead, "when a tipper gives inside information to a trading relative or friend, the jury can infer that the tipper meant to provide the equivalent of a cash gift." "In such situations, the tipper benefits personally because giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds." Petitioner contends that there is no basis in his plea allocution or elsewhere for the conclusion that he "(a) received or agreed to receive a benefit in exchange for the tip; or (b) had a relationship with [Tucker] that was sufficiently close . . . to make [Tucker's] trading profit a benefit to Mr. Marshall." Petitioner insists that there is no evidence that Petitioner received

a “tangible benefit” after sharing information with Tucker, so insider trading liability can attach only if there was “a meaningfully close personal relationship” between Petitioner and Tucker. Petitioner avers that there is no evidence such a relationship existed. Here, Petitioner clearly stated during his guilty plea allocution that he provided information to Tucker with the expectation that Tucker would trade on that information. (“I gave hints about those merger discussions to a colleague with the knowledge that he would likely trade on that information and I know in fact that he did trade on that information.”) In addition, Petitioner described Tucker as a “colleague” in his allocution, thus indicating that he and Tucker had some type of relationship. In fact, Petitioner and Tucker had known each other and worked together for at least a decade before the events at issue occurred. Accordingly, there is a basis in Petitioner’s plea allocution and elsewhere for the conclusion that Petitioner “disclosed [inside information] with the expectation that [Tucker] would trade on it, and that the disclosure resemble[s] trading by [Petitioner] followed by a gift of the profits to the recipient.” Moreover, the Information to which Petitioner pled guilty states that Petitioner and Tucker agreed to share profits resulting from trades carried out pursuant to the insider trading scheme. The Information also states that as a result of the trading scheme, Marshall and Tucker “made a significant profit.” The Information thus provides a basis for a conclusion that Petitioner received or expected to receive a pecuniary benefit from providing material non-public information to Tucker. Sufficient evidence thus supports Petitioner’s conviction for conspiracy to commit securities fraud. DECISION AND REMEDY: Petition DENIED. SIGNIFICANCE OF THE CASE: This case demonstrates how a court considers a case of insider trading, especially the issue of whether a tipper stood to gain from tipping insider information. CRITICAL THINKING What do you think is the strongest argument Marshall could make to justify his claim that he did not engage in insider trading? ETHICAL DECISION MAKING If he had thought about the universalization test, how might Marshall’s behavior been different? Why? Page 565Page 566 Section 16(B) Under Section 16(a) of the 1934 act, certain large stockholders, executive officers, and directors are considered statutory insiders. All statutory insiders must file a report detailing their ownership and trading of the corporation’s securities. To prevent statutory insiders from using inside information for their personal gain, Section 16(b) of the 1934 act requires statutory insiders to return all short-swing profits, or profits made from the sale of company stock within any six-month period by a statutory insider, to the company. Even if the insider did not use the inside information to make the transaction, all short-swing profits belong to the corporation. Section 16(b) imposes strict liability

on statutory insiders who earn short-swing profits. In other words, violators cannot use lack of intent or lack of knowledge as a defense. Certain transactions, however, such as bankruptcy proceedings, are exempt from Section 16(b). CASE Nugget Using Misappropriation Theory to Establish a 10b-5 Violation United States v. Carpenter U.S. Court of Appeals for the Second Circuit 791 F.2d 1024 (1985) In 1981, R. Foster Winans wrote the "Heard on the Street" column for The Wall Street Journal. He was aware of the Journal's policy that all news material employees gained in the course of their employment was confidential. However, Winans and Carpenter, a news clerk at The Wall Street Journal, participated in a scheme with stockbrokers Felis and Brant. Winans provided the brokers with securities-related information that was about to be printed in the "Heard on the Street" column. Using this information, Felis and Brant would buy or sell the relevant securities. Carpenter was a messenger between Winans and the stockbrokers. The net profit on the use of the information for securities trading was \$690,000. Felis's brokerage firm noticed a correlation between the "Heard on the Street" column and the trading in Felis's account. Although Felis denied the connection, he began making plans to cover up the trading. Soon, the SEC began an investigation. Later, Winans and Carpenter revealed the entire scheme to the SEC. The SEC sued under Section 10(b) of the Securities Exchange Act of 1934, arguing that the securities information had been misappropriated. The district court found Winans and Felis guilty of misappropriation under 10(b), and Carpenter was convicted for aiding and abetting the commission of securities fraud. They appealed. The appellate court held that the newspaper employees and brokers, acting in concert, criminally violated the federal securities laws by misappropriating material, nonpublic information, in contravention of established policies of the newspaper, for their own profit in the purchase and sale of securities. This type of fraudulent act is the type of deceptive act that the securities laws are designed to protect against. It therefore falls under the broad prohibition of "any device, scheme, or artifice to defraud." Proxy Solicitations A proxy is a writing signed by a shareholder that authorizes the individual named in the writing to exercise the shareholder's votes (corresponding to his shares of stock) at a shareholders' meeting. Corporate managers often contact shareholders to request them to give a certain manager authority to vote on their behalf in an upcoming meeting. This process of obtaining authority to vote on behalf of shareholders is called proxy solicitation. Because the proxy solicitation process is potentially susceptible to fraud, the SEC regulates the proxy solicitation process. Page 567 Section 14(a) states that an issuer making proxy solicitations must also furnish a written proxy statement to

shareholders. This statement must disclose to the shareholder all facts pertinent to the voting that will occur in the meeting. See Exhibit 23-2 for an excerpt from an example of a proxy statement that explains the purpose of the statement. Exhibit 23-2 Proxy Statement Opening Proxy Statement Excerpt General Electric Company 3135 Easton Turnpike Fairfield, Connecticut 06828 This proxy statement is furnished in connection with the solicitation of proxies by General Electric Company on behalf of the Board of Directors for the 2010 Annual Meeting of Shareowners. Distribution of this proxy statement and a proxy form to shareowners is scheduled to begin on or about March 9, 2010. You can ensure that your shares are voted at the meeting by submitting your instructions by telephone or by Internet, or by completing, signing, dating, and returning the enclosed proxy form in the envelope provided. Submitting your instructions or proxy by any of these methods will not affect your right to attend the meeting and vote. A shareowner who gives a proxy may revoke it at any time before it is exercised by voting in person at the annual meeting, by delivering a subsequent proxy, or by notifying the inspectors of election in writing of such revocation. Source: General Electric, "Notice of 2010 Annual Meeting and Proxy Statement,"

www.ge.com/pdf/investors/financial_reporting/proxy_statements/ge_proxy_2010.pdf. Violations Of The 1934 Act The 1934 act authorizes both civil and criminal penalties. If an individual engages in insider trading, a violation of Section 10(b) or Rule 10b-5, they have committed a criminal offense punishable with a fine up to \$1 million, a prison sentence up to 10 years, or both. If a defendant did not know of the rule they violated, they cannot be imprisoned. If a partnership or corporation engages in insider trading, it is subject to fines up to \$2.5 million. Both the SEC and private parties can bring civil actions against violators of the 1934 act. The SEC investigates alleged violations under the 1934 act. In the process of an investigation, the SEC can enter into consent orders with defendants or seek injunctions to stop certain actions by defendants. Perhaps the most useful tool the SEC has for punishing those engaging in insider trading is the Insider Trading Sanctions Act of 1984, which permits the SEC to sue any individual who violates the 1934 act or who helps another person to engage in insider trading in violation of that act. If the SEC succeeds in demonstrating its claim, courts may assess a civil penalty up to triple the profits gained or losses avoided by the defendant. Congress expanded the SEC's authority to punish violators of the 1934 act when it passed the Insider Trading and Securities Fraud Enforcement Act of 1988. This act subjects more individuals to civil liability for insider trading and grants the SEC power to award bounty payments

(government rewards for acts beneficial to the public) to insider-trading whistle-blowers. Private parties may also sue violators of the 1934 act. A private party may seek rescission of a contract to buy securities or may recover damages based on the violator's profits. If the court rules that an individual is liable for violations of the 1934 act, they can seek contribution from others, such as accountants or lawyers, who shared responsibility for the violation. Significant 2021 Amendments to the SEC Act of 1934 On January 21, 2021, Congress passed amendments to the SEC Act of 1934 that significantly increased the ability of the SEC to penalize those who violate the Securities laws¹¹. Specifically, these amendments Page 568 Authorize the SEC to seek disgorgement in the US District Court of "any unjust enrichment" from an individual who has violated federal securities laws; Establish a 10-year statute of limitations for the SEC to seek disgorgement of funds related to the violation of scienter-based conduct under the Exchange Act, the Securities Act of 1933, or the Investment Advisers Act of 1940; Toll the Statute of limitations for any time during which subjects of an enforcement actions are outside of the United States; and Apply the new rules to any action that was pending on, or commenced after, the date the amendments were passed. While it is too early yet to know the full impact of these amendments, when they were passed, some commentators predicted that the Enforcement Division's disgorgement recoveries would rise significantly over the next few years, and that the amendments would significantly increase the Enforcement Division's leverage in negotiating settlements of enforcement actions.

Regulation of Investment Companies LO 23-4 Recall the legislative Acts that regulate investment companies. In the past century, smaller investors have become important players in securities markets. Investment companies facilitate their involvement in securities markets by purchasing a large, diverse portfolio of securities and managing it on behalf of small investor-owners. However, because small investors often lack the resources and ability to supervise investment companies adequately, they can be subject to fraud and exploitation. E-Commerce and the Law Marketing Securities on the Internet Perhaps one of the most important and exciting developments in securities regulations is the explosion of the securities market on the Internet. The web permits companies to sell securities in an online initial public offering (IPO), thereby avoiding the expensive filing requirements of a

traditional IPO. For example, some websites allow customers to buy and sell securities online. This technology, however, presents a greater opportunity for fraud because anyone can create a website. Several cases of securities fraud have occurred simply because a company has offered so-called free stock over the Internet. The SEC has issued cease-and-desist orders against companies that illegally offered free stock on their websites because they had not registered their stocks with the SEC. Another type of online fraud, called pumping and dumping, occurs when an owner of a particular stock tells other investors about the virtues of the stock, artificially increasing demand for the stock and pumping up its price, only to sell (dump) it for a quick profit. Unregulated message boards on the Internet permit pumping and dumping on a fast and efficient basis. In response to the increasing use of this method of stock price manipulation, the SEC has pursued harsher and more frequent prosecution of individuals who engage in pumping and dumping online. The web also provides potential investors with access to enormous amounts of information about securities. For example, the SEC maintains the Electronic Data Gathering, Analysis, and Retrieval (EDGAR) database to help investors access information about IPOs and other documents filed with the SEC. Visit www.sec.gov/edgar.shtml to learn more about EDGAR. SEC regulations apply to online advertising and securities transactions. When a company delivers a paperless prospectus, it is subject to the following rules: The company must provide timely and adequate notice of the delivery of information. The company must use an easily accessible communication system, such as the Internet. The company must create evidence of the delivery of information. To prevent exploitation of small investors, Congress passed the Investment Company Act of 1940, providing for SEC regulation of investment companies. Congress later expanded the SEC's power to regulate investment companies under the Investment Company Act Amendments of 1970 and the National Securities Markets Improvement Act of 1996. Page 569 The Investment Company Act defines an investment company as any entity (1) that is engaged primarily in the business of investing, reinvesting, or trading in securities or (2) that is engaged in such business and in which more than 40 percent of the company's assets are investment securities. The act excludes a number of institutions, however, including banks, insurance companies, savings and loans, and finance companies. The act requires all investment companies to file a notification of registration with the SEC. In addition, they must file annual reports with the SEC and hold all securities in the custody of a bank or member of the stock exchange. The act prohibits investment companies from purchasing securities on the margin (borrowing money to purchase

securities), selling short (selling securities that the company does not yet own), or participating in joint trading accounts.

State Securities Laws LO 23-5 Identify state laws that regulate securities. Not only must issuers obey federal securities regulations, but they are also subject to state securities laws, often referred to as blue-sky laws. These laws regulate the offering and sale of purely intrastate securities. Hence, although certain securities are exempt from federal securities regulation, they may be subject to state securities laws. Many state securities laws serve functions similar to those of federal securities laws. For example, many states have laws requiring registration of securities issued within the state and requiring disclosure of certain information. Moreover, state laws regulate securities brokers and dealers. Although the purposes of state and federal securities regulations overlap, the specific regulations differ. Consequently, to encourage greater coordination between federal and state securities laws, most states have adopted the Uniform Securities Act. CASE OPENER WRAP-UP The Martha Stewart Case Although the SEC sought to charge Martha Stewart with illegal insider trading, a grand jury did not indict Stewart on that charge. The grand jury did, however, indict Stewart and her broker on nine criminal charges, including securities fraud, obstruction of justice, and conspiracy. Stewart pled not guilty to all charges. The district court threw out the securities fraud charge on grounds that “no reasonable jury could find it to be accurate.” A week later, however, a jury convicted her of the four remaining counts against her, all of which related to her statements to SEC investigators in their investigation of her sale of ImClone stock. The jury sentenced her to five months in a minimum-security prison. A federal appellate court upheld her sentence.¹² PRACTICAL TIPS for Business Managers Insider business information can sometimes be easy to come upon and presents the temptation of using it to engage in insider trading. However, being convicted of insider trading can cost huge amounts of money and ruin a career. It may be best to think twice before using insider information for illegal gains. As this chapter demonstrates, registering securities to be offered to the public is a complex and multi-step process. It may be wise to seek counsel before attempting to register securities to ensure that you make no fatal mistakes in the process. If you manage an investment company, the SEC provides a whole other set of regulatory hoops to jump through. Be sure to keep up on the rules and regulations so that you do not, for example, miss an annual report and find yourself in trouble.

SUMMARY What Is a Security? As defined by the Howey test, a security is an investment in a common enterprise with the reasonable expectation of profit gained predominantly from others' efforts. **Securities Regulation** The Securities and Exchange Commission (SEC) was created in 1934 to enforce securities laws, interpret provisions of securities acts, and regulate the trade of securities as well as the activities of securities brokers, dealers, and advisers. **The Securities Act of 1933** A registration statement is a document containing a description of the securities offered for sale, an explanation of how proceeds from the sale will be used, a description of the registrant's business and properties, information about the management of the company, a description of any pending lawsuits, and certified financial statements. A prospectus is a written document that is similar to a registration statement and is used as a selling tool for potential investors. **Periods of the filing process** Prefiling period Waiting period Posteffective period **Unregistered, unrestricted securities** are exempt from the registration process. They include Securities issued by governments, including municipal, state, and federal governments. Securities issued by nonprofit issuers, such as religious institutions or charitable organizations. Securities issued by financial institutions supervised by banking associations. Securities issued as a result of corporation reorganization in which one security is exchanged for another security. Stock dividends and stock splits. Insurance and annuity contracts issued by insurance companies. Securities issued by federally regulated carriers (i.e., railways). Short-term notes with a maturity date that does not exceed nine months. Securities sold before July 27, 1933. An issuer's offer of up to \$5 million in securities in a 12-month period. Certain kinds of transactions are exempt, including the following: Limited offers involve small amounts of money or are offered only to sophisticated investors. There are four possible exemptions: Private placement exemption: Exempts private offerings of securities. Rule 505: States that private offerings may not exceed \$5 million in a 12-month period, and firms do not have to believe that investors have a reasonable ability to evaluate risk. Rule 504: Exempts noninvestment firms that offer no more than \$1 million in securities in a 12-month period. Section 4(6): Exempts securities offered only to accredited investors for an amount less than \$5 million. Intrastate issues exempt local investors in local businesses. Resales exempt transactions by any person other than an issuer, underwriter, or dealer. Restricted securities are securities acquired under Rule 505, Rule 506, or Section 4(6) that must

be registered for resale unless the investor follows Rule 144 or Rule 144(a). Violations may result in Administrative action Injunctive action Criminal prosecution The Securities Exchange Act of 1934 Section 10(b): Regulation that prohibits the use of manipulative and deceptive devices to bypass SEC rules. Insider trading: Trading in which a company employee or executive uses material inside information to make a profit. Misappropriation theory: Theory that an individual who wrongly acquires and uses inside information for profit is liable for insider trading. Tipper/tippee theory: Theory that an individual who receives material inside information as a result of an insider's breach of duty is guilty of insider trading. Statutory insiders: Certain stockholders, executive officers, and directors who must file a report detailing their ownership and trading of the corporation's securities. Short-swing profits: Profits made from the sale of company stock within any six-month period by a statutory insider; according to Section 16(b), these profits must be returned to the company. Proxy: Document that authorizes an individual to vote a shareholder's share of stocks at a shareholders' meeting. Proxy solicitation: Process of obtaining the authority to vote on behalf of a shareholder. Violations may result in Criminal penalties. Civil penalties. Suits against those involved in insider trading under the Insider Trading Sanctions Act of 1984. Regulation of Investment Companies The Investment Company Act of 1940 provides for SEC regulation of investment companies. The act requires all investment companies to file a notification of registration with the SEC, file annual reports with the SEC, and hold all securities in the custody of a bank or member of the stock exchange. State Securities Laws State securities laws serve functions similar to those of federal securities laws and include blue-sky laws. Blue-sky laws regulate the offering and sale of securities within the state only.

Point/Counterpoint Should Cryptocurrencies Be Regulated as Securities? YES NO One aspect of cryptocurrencies that many proponents tout is its possibility for decentralization—that is, there is no institution behind the currency that can affect its use and value. While several cryptocurrencies are decentralized, many more are being issued by firms and institutions as a method of raising funds much like any other security. Even some of the more popular “decentralized” cryptocurrencies like Bitcoin and Ethereum are being widely used as investments, whether they were intended to be or not. Thus, as cryptocurrencies become more popular and as more people begin to treat

them like securities, there is an increasing need to regulate them as securities. There is a reason many people describe the world of cryptocurrency as the Wild West. There are numerous scams and few rules to protect investors from market manipulation or insider trading. Additionally, investors are not protected from cryptocurrency platforms or exchanges that go bankrupt or get hacked and lose someone's entire portfolio. Regulation could go a long way to protecting these investors. The fact that cryptocurrency is gaining in popularity and that more people are starting to invest in it means that cryptocurrencies may start impacting the larger world economy. In fact, in response to the extreme volatility of cryptocurrencies like Bitcoin, some cryptocurrencies have begun to peg their value to real-world commodities like gold or dollars. Doing so may help keep these currencies stable, but it also draws them into the traditional economy. Some of these cryptocurrencies back up its tokens in types of short-term credit; a run on these currencies could affect the entire short-term credit market. Finally, if cryptocurrencies ever want to truly become mainstream, regulation may be necessary. With all the highs and lows of the stock market, people continue to invest in stocks because they have confidence that there are rules to even the playing field and protect their investments. No such rules exist in the world of cryptocurrency, and many people are wary of its high volatility, lack of protections, and use in illicit activities. Creating a regulatory scheme around cryptocurrencies is more or less required before any major financial institution starts taking cryptocurrencies seriously as an investment, let alone the average American. If there is any one overarching aim and purpose of cryptocurrency, it is decentralization. Cryptocurrency was created in large part to enable financial transactions without the involvement of big banks and governments. Cryptocurrency empowers individuals to manage their money their way without an institution watching over their shoulder and meddling with the value of their cryptocurrency assets. The idea is to take power away from banks and corporations; regulation is simply a way for these institutions to get involved and assert their powerful influence over something explicitly designed to avoid them. In other words, regulation defeats the entire point of cryptocurrency. It is because cryptocurrency has been allowed to take its own path uninfluenced by powerful financial institutions that it has gotten to where it is today. In the absence of these institutions, the world of cryptocurrency has been one of constant innovation and has changed the ways we think about currency, fundraising, and finance in general. The lack of regulation has allowed for creative solutions in all of these areas, as well as flexible models that do not have to adhere to an outside set of rules. Regulation would negatively impact the rampant

innovation of the cryptocurrency world and prevent the invention of new ways consumers and businesses can use their money. Finally, cryptocurrency regulation is not going to make people follow the rules. Because cryptocurrency is so tied to the online world and is dedicated to decentralization, American regulation of cryptocurrency will simply push it outside of American jurisdiction. People will continue to use cryptocurrency, but the money and jobs generated by this burgeoning industry will not be benefiting the American economy. It is better for the U.S. to allow cryptocurrency to flourish within its borders rather than push it elsewhere.

Questions & Problems What was the stimulus for the creation of securities regulation? State the purposes of the two main federal securities laws. What is the function of the SEC? Explain the process of registering securities. Why are certain securities transactions exempt from the registration process? Why is it illegal to use inside information in making securities transactions? How does the misappropriation theory apply to insider trading? SAC Ariad Pharmaceuticals, Inc. (Ariad), is a small Cambridge-based pharmaceutical company whose shares are traded on the Nasdaq exchange. Maureen Curran joined Ariad in 2006 and eventually became the company's "head of pharmacovigilance and risk management." During the time in question, Ariad was developing a new drug called Iclusig to treat chronic myeloid leukemia. Curran oversaw the collection and disclosure of data regarding Iclusig's safety and side effects as the drug underwent clinical testing. Because of Curran's role in the company, she became privy to confidential information regarding Iclusig's viability as a marketable drug. As a result, both she and her spouse, Dr. Harold Altvater, fell under Ariad's insider trading policy. Altvater had a history of trading in Ariad stock through his private brokerage accounts, but according to Curran, in September or October of 2013, she told Altvater to cease trading in Ariad stock because of a company-imposed blackout period. Despite this warning, over the next several months Altvater made three series of trades in Ariad stock that took place just before the public disclosure of information concerning the US Food and Drug Administration's assessment of Iclusig and that drug's path toward continued use. Altvater sat for a deposition with the US Securities and Exchange Commission on July 28, 2016, during which he answered questions regarding what information about Ariad he had learned from Curran and whether that information influenced his decisions to trade in Ariad stock. Later, Altvater

was charged and convicted of securities fraud. Altwater appealed his conviction. Do you think Altwater has a strong basis for an appeal? Should Curran have any liability as a potential tippee? Source: *United States v. Altwater*, 954 F.3d 45 (1st Cir. 2020). Page 573

Here we have yet another pharmaceutical insider trading case. Elan Corporation and Wyeth were jointly developing an Alzheimer's drug. Steven Martoma, a portfolio manager at a hedge fund, began purchasing shares in Elan and Wyeth and told the owner of the hedge fund, Steven Cohen, to do so as well. Martoma hired expert networking firms and doctors to provide him with information regarding the success of the drug's clinical trials. Although many of these doctors had contractual obligations to keep this information secret, they told Martoma about "two major weaknesses in the data" that called into question the efficacy of the drug. Martoma called Cohen and told him to reduce his position in Elan and Wyeth in case the share price fell. Sure enough, a week later the results of the trials were released, and the share price of both companies substantially declined, earning Martoma and Cohen hefty sums and avoiding hundreds of millions in losses. However, Martoma was investigated by the SEC and convicted of insider trading. He appealed his conviction, arguing that he did not have a "meaningfully close personal relationship" with the doctors that provided him insider information and that the doctors had not received any "objective, consequential . . . gain of a pecuniary or similarly valuable nature" in exchange for the information. Do these factors matter in an insider trading case? How did the court rule? Source: *United States v. Martoma*, 869 F.3d 58 (2nd Cir. 2017).

Stacey Greenfield sued the Cadian entities under Section 16(b) of the Securities Act of 1934. The Cadian entities which were a number of investment funds and partnerships. Cadian Fund LP and Cadian Master Fund were two investment funds which shared a general partner, Cadian GP, LLC, which Eric Bannasch was the sole managing member. Cadian Capital Management, LP, also owned by Bannasch, served as the investment manager of the investment funds. In addition, all financial decisions for all Cadian entities pertinent to this case were made by Bannasch. Recall that Section 16(b) requires all statutory insiders to return short-swing profits. Statutory insiders also include "beneficial owners" of more than 10 percent of any equity security of a company. In this case, Greenfield sued the Cadian entities as a group for buying and selling Infoblox common stock shares while collectively owners of at least 10 percent of Infoblox. In filing this complaint, Greenfield also asserted that the Cadian entities are "inexorably intertwined" and could therefore be held liable under Section 16(b). The Cadian entities moved for summary judgment for failure to state a claim. Do you think groups of

individuals or other entities such as companies and investment funds should be collectively classifiable as beneficial owners and therefore liable under Section 16(b)? What are the implications if they are? What are the implications if they are not? How do you think the court decided this question? Source: *Greenfield v. Cadian Capital Management, LP*, 213 F. Supp. 3d 509 (2016). The Garrett Group, a real estate company, was in financial trouble after the recession. It informed its creditor, CVB Financial Corporation that it could not make loan payments. After CVB restructured the Garrett Group's loan, Garrett indicated it still could not fulfill its debts to CVB. Despite the Garrett Group's statements, CVB represented to the SEC that the Garrett Group were financially solvent and would be able to pay its loans with ease. In 2010, the SEC filed a subpoena seeking information about CVB's loan underwriting process. A month after the subpoena, CVB wrote off \$34 million in loans to the Garrett Group. CVB's stock also dropped 22 percent as a result of the subpoena and writing off the loan. A class action was subsequently filed against CVB alleging violations of Section 10(b) and Rule 10b-5 of the Securities and Exchange Act of 1934. Consider the following statements made by CVB: "[t]he overall credit quality of the loan portfolio is sound;" "CVB's credit metrics are superior" to those of its peers; "strong credit culture and underwriting integrity remain paramount at CVB;" and "CVB's culture has limited its exposure to problem credits." Do you think any of the four statements on their faces, could be considered materially misleading under Rule 10b-5? Why or why not? What do you think is necessary for a statement to be considered materially misleading? Source: *Lloyd v. CVB Financial Corp.*, 811 F. 3d 1200 (2016). Plaintiffs allege that the pharmaceutical company Sanofi, along with its predecessor and three company executives, made materially false or misleading statements regarding its breakthrough drug, Lemtrada, designed to treat multiple sclerosis (MS). In part because of Lemtrada's unique treatment design, Genzyme used a single-blind study in its early clinical trials. In a single-blind study, either the researcher or the patient does not know which drug was administered. The FDA prefers double-blind studies, and repeatedly told Defendant the lack of double-blind studies was troubling, but the FDA continued to provide the company encouragement. Plaintiffs allege that while Lemtrada was undergoing Phase III clinical trials prior to FDA approval, Sanofi misled investors by failing to disclose that the FDA had repeatedly expressed concern with Sanofi's use of single-blind studies and had encouraged Sanofi to use double-blind studies in its clinical trials. Plaintiffs allege that these omissions misled investors and artificially inflated the value of Plaintiffs' contingent value rights (CVRs), specialized financial instruments

whose value is tied to the achievement of certain “milestones.” While defendants remained optimistic, the FDA did not approve the drug before the milestone was met, causing the value of the stock to fall. Plaintiffs’ filed their action alleging violations of Sections 10(b), 18, and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. Section 78a et seq., and Sections 11 and 12 of the Securities Act of 1933, 15 U.S.C. Sections 77a et seq. Defendants filed a motion to dismiss, which the trial court granted, finding that the defendants had made no false or misleading statements but had merely expressed their optimistic beliefs as to how the FDA would act in the future. How do you believe the appellate court ruled in the case? Why? Source: Gen. Partner Glenn TONGUE, Deerhaven Capital Management, et al v. Sanofi Pharmaceuticals, Inc., Consolidated, et al. caselaw.findlaw.com/Us-2d-circuit/1727858 (2016). Page 574

The Brian B. Sand & Zachary B. Sand Joint Trust (the Trust) sued the Biotechnology Value Fund (BVF) under Section 16(b) of the Securities Exchange Act of 1934. Mark Lampert controlled BVF as well as four other hedge funds at issue: Biotechnology Value Fund, LP; Biotechnology Value Fund II, LP; Investment 10, LLC; and MSI BVF SPV, LLC. Lampert was the sole officer and director of each of these funds, either directly or through BVF. In addition, all financial decisions for all of the entities were made by Lampert. Recall that Section 16(b) requires all statutory insiders to return short-swing profits. Statutory insiders also include “beneficial owners” of more than 10 percent of any equity security of a company. In this case, the Trust sued BVF, Lampert, and the other hedge funds for buying and selling common stock shares of Oncothyreon, Inc., of which the Trust is a shareholder, while collectively owning at least 10 percent of Oncothyreon. The Trust argues that the “interrelated nature and structure of [defendants]” means that Lampert and the hedge funds could be held liable under Section 16(b). The defendants moved for summary judgment, arguing that the Trust’s allegations were insufficient to prove that Lampert and BVF actually held 10 percent of Oncothyreon shares. Do you think groups of individuals or other entities such as companies and investment funds should be collectively classifiable as beneficial owners and therefore liable under Section 16(b)? What are the implications if they are? What are the implications if they are not? How do you think the court decided this question? Source: Brian B. Sand & Zachary B. Sand Joint Trust v. Biotechnology Value Fund, L.P., No. 16-cv-01313-RS (N.D. Cal., 2017).

